GEORGIA MICROFINANCE STABILIZATION AND ENHANCEMENT PROGRAM

Proposed Legislative Amendments to Clarify and Enhance the Powers and Activities of Microfinance Institutions by Removing Legislative Flaws Which Prevent or Hinder Their Viability and Growth as Significant Contributors to Georgia's Financial Sector

A PROJECT BY:

CHEMONICS INTERNATIONAL INC.
BANKWORLD INC
SHOREBANK ADVISORY SERVICES

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Giorgi Otaridze
Martin W. McCormack

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I-INTRODUCTION

Sustainability and growth of the specialized institutions which provide different kinds of microfinance services within a country's financial system cannot be achieved without a conducive legislative and regulatory environment.

Therefore, Task I of the GMSE Project's Work Plan is the establishment of a clear and favorable legislative and regulatory framework, including fair tax treatment, to support and encourage the stability and sustainable development of the country's various types of microfinance institutions.

Because development funding for NGO microfinance institutions might not always be available in the future to the extent it has been in the past, it is critical that these institutions move toward stability and sustainability by improving their management methodologies and by preparing to become financially self-sufficient. This new direction will entail the institutions' becoming more commercially oriented in their objectives, powers and activities.

This change in orientation will ultimately benefit Georgia's population by creating jobs and reducing poverty through increasing credit and savings services to small and medium-sized enterprises, consumers, householders and the poor. The new pathway will complement the financial services of other players in the sector such as commercial banks and other types of non-bank financial institutions. It will position local microfinance institutions, both depositary and non-depositary, both large and small, to begin evolving toward a needed niche within a secure and productive future for Georgia's finance community.

That niche and that future are Team GMSE's end-goals.

In view of the foregoing, Team GMSE believes that the 32 legislative amendments to selected statutes which it proposes below will together constitute the first step toward reaching the above end-goals. When enacted, these amendments will have the effect of removing from the law the ambiguities, constraints and impediments which are current barriers to the improved viability and growth of Georgia's microfinance institutions and the transition and development of their clientele.

The nine statutes GMSE proposes to amend in part are the following.

(i) The Civil Code of Georgia
(ii) The Law of Georgia on Grants
(iii) The Law of Georgia on Activities of Commercial Banks
(iv) The Law of Georgia on Fees for Notary Services
(v) The Law on State Fees of Georgia
(vi) The National Bank Act of Georgia
(vii) The Tax Code of Georgia
(viii) The Law of Georgia on Entrepreneurs
(ix) The Civil Procedures Code of Georgia

Each amendment proposal is set forth below in narrative fashion on an Article-by Article basis within a particular law. Exact language proposed to be added, deleted or substituted with

respect to a particular Article is highlighted. In each case, this proposed language is followed by a brief statement reciting the problem to be solved by the proposed amendment and describing the benefits the amendment will bring to microfinance institutions, and/or to the financial sector in general from the perspective of an improved legislative framework.

A note on the translations of the proposed amendments is found in Section III below.

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II-THE RECOMMENDED AMENDMENTS

A- Civil Code

1. Article 5 (1)

Add "under current Georgian law, excluding court decisions and criminal law" to the end of the sentence.

This added language will have the effect of stopping courts (who sometimes misunderstand the purpose and role of MFIs), from erroneously searching for and finding, at the behest of anti MFI litigants, simplistic and questionable legal justification, sometimes in the criminal code, to support arbitrary and uninformed interpretations of cases involving the powers and activities of MFIs. The results can prejudice MFIs. These kinds of decisions are dangerous for the MFI industry. For example, in the past they have been used as precedent by other courts and government officials for similar kinds of erroneous rulings against other MFIs.

2.Article 25(2)

Insert the words "and stipulated in its charter" after the word "law" in line 2.

In its present form, the language is too broad since it permits both commercial and non-commercial companies to engage in legal activities which are not stipulated in their charters. This kind of language devalues charters. This change is important for the legitimacy of various kinds of MFIs because of the possibility of their engaging in several kinds of specific activities both commercial and non-commercial and of being prohibited from engaging in others. This inherent power to specify exact activities in their charters is particularly important to MFIs. And it is especially so in view of proposed tiered regulation, which will be geared to powers to engage in specific activities with limits and prohibitions on others.

3.Article 25(4)

In the Georgian language version, the word "registration" will be changed to "foundation" to reflect the reality that certain liabilities are undertaken before actual registration.

The English version is correct in this regard and needs no amending.

4. Article 30 (1)

A new sentence should be added as a third sentence in the Article as follows: "Entrepreneurial activity may also be legally considered as a primary activity for a foundation or union in its social mission if so stipulated in its charter."

This change will permit unions and foundations to engage in financial activities as powers properly incidental to their primary social missions thus protecting them against allegations that they are in violation of their charters because they wrongfully engage in entrepreneurial activities. Such alleged violations threaten them with the possible revocation of their charters by a court or the Ministry of Justice, effectively putting them out of business.

5. Article 31 (2)

The last sentence of the Article should be eliminated because in its present form, it could be interpreted as authorizing the Ministry of Justice to refuse to register a foundation or to revoke its registration on the grounds of inadequate resources. It is not the function of the Ministry of Justice to regulate the resources of foundations at all much less to deny them the right to operate based on the level of their resources.

6. Article 31 (3)

The following sentence should be added at the end of the Article:

"such application signatures may be delegated by any such founders and members to one or more persons through valid powers of attorney"

This language will considerably lighten the registration burden on unions by removing the requirement that each and every member of a union (where membership might number in the hundreds) sign the registration documentation.

7. Article 34

The following sentence should be added at the end of the Article.

" Small changes other than changes in the name, purpose, supervisory board or managing board membership or in governance procedures" of a union or foundation need not be in notarial form and no registration fee shall be necessary to effectuate such changes."

The reason for this recommendation is that currently microfinance institutions, particularly small ones, are burdened with full registration fees when they wish to make minor changes in their charters. This provision will relieve them of that burden.

8. Article 35

1. The following language should be inserted after the word “activity” in line 2.

“except in cases of the kinds of activities set forth in Article 30 (1)

2.The following sentences should be added at the end of the Article:

“any such revocation shall be preceded by 30 day written warning notice setting forth the reasons for the revocation and affording an opportunity to be heard in opposing it”.

These changes accomplish the following improvements

1. Due process is now expressly added to the law for the benefit of microfinance institutions because now authorities may no longer arbitrarily revoke their charters, suddenly putting them into liquidation without affording them their constitutional rights in keeping with proper notice along with the opportunity to be heard and defend.

2. Formerly, it had been wholly prohibited for unions and foundations to engage in entrepreneurial activity as a primary activity prior to our recommended amendment in Article 30(1). This change will conform to our new amendment legitimizing entrepreneurial activities for microfinance institutions. Formerly they were subject to liquidation by reason of the mere fact that they engaged in finance as an adjunct to their social purpose.

9.Article 42

Delete the last sentence and substitute the following sentence for it.

“Members of a Committee may be elected from among union members as well as from outside of its membership.”

The purpose of this recommended amendment is to improve the governance of unions permitting them to have Committee voting members with perspectives which are not those solely of insiders in conformity with fundamental international standards.

10. Article 43

Add a new sentence as follows:

“No member of an advisory body may at the same time be a member of the union’s managing board”.

The purpose of this recommended amendment is to improve the governance of unions preventing clear conflicts of interest in their managements because advisory boards both recommends and approve many of the important decisions of

a union's management. It is unacceptable to accord persons the power to implement their own advice since they thereby impose it in an executive manner.

11. Article 48(1)

Add a new sentence to the Article as follows

"No person may be at the same time a member of a foundation's Supervisory Council and its Management Board".

This language conforms the law of foundations to Civil Law governance

12. Article 254

Add the words "and cash" after "property on line one.

This amendment will for the first time expressly authorize the taking of cash as collateral, a principal activity of many microfinance institutions It will thus prevent the possibility of such an institution from being charged by misunderstanding authorities of taking deposits without a proper license.

13.Article 625

Delete the entire language and substitute as follows:

"Interest on loans may be agreed by parties to be pegged to any legal standard and may be based on prevailing market rates for similar loans "

This change is recommended for the purpose of conforming loan practices of all kinds of institutions to international standards of freedom of contract. It eliminates the statist notion that all lenders and borrowers must conform to state money auction rates or rates imposed by the National Bank.

B-Grants Law

14. Article 2 (2)

Add the following language at the end of the sentence.

"except for to foundations or unions which engage in authorized financial activities for social ends consistent with their charters".

This recommended amendment is critical for local microfinance institutions and microentrepreneurs because it puts a stop to the authority and practice of Tax Inspectors to assess grant money as taxable income "off the top" upon receipt by both foundations and unions engaged in microfinance activities. These institutions also pay profit taxes at a rate of 20% on these monies where they

generate profits by being deployed in lending activity. This is bad policy in that it unfairly imposes double taxation against local foundations and unions thus discouraging donor funding.

C- Commercial Banking Law

15. Article 1.

1.The term "non-bank financial institution" should be added to the defined terms listed in the amendment dated December 28, 2003. The definition should read as follows:

"Non-bank financial institution" means a financial institution which is in the business of financial transacting for clients but which is not licensed to receive demand deposits (current accounts)".

2.The term "deposit" should be amended to read as follows:

"Deposit means an amount paid to a bank by its customer which becomes the absolute liability of the bank to the customer and which is subject to agreement with the bank to repay it under agreed terms or on demand with or without interest and which has absolute priority in liquidation over other creditors of the bank".

The following Articles should be changed to substitute the term "non-bank depositary institution" to "non bank financial institution".

a- Article 1- the unnumbered definition of "control";
b- Article 3.4 -(a), (b), (g) and (d)
c- Article 14. 4 (b)
d- Article 15.2 (b)

The reasons for these recommendations are as follows:

1. The definition of bank and deposit should be expanded to properly define them. Additionally non-depositary institutions such as microfinance institutions should now be included in the nomenclature. This new term will have the effect of placing microfinance institutions under appropriate regulation of the National Bank when read in tandem with the amended National Bank Act which, under our proposed amendment, now authorizes such regulation, most likely on a tiered basis.

2. In order to actualize this change throughout the Commercial Bank Law, the above adjustments will be made at all appropriate points.

16. Article 25 (1)

Add the words "non-bank financial institutions: after "commercial bank" in line 1.

D-Law on Fees for Notary Services

17. Article 19(2)

Delete the sentence after the words "shall be an amount" and substitute the words "of 100 GEL."

The current fees chargeable to a sizable foundation for a routine certification can be
unduly burdensome for them because it is based on its resource base. We believe that this measure unjustly discriminates against the larger foundations and is not based on rational policy but has the effect of penalizing those foundations which bring the most benefits to the country. It is therefore recommended that the fee be made flat, the value of certification (a ministerial act only) being in reality the same for foundations of all sizes.

E-Law on State Fees

8. Article 5(19)

Substitute the words "financial institutions" for the words "depositary institutions" on the second and last lines.

This recommendation will serve to expressly exempt microfinance institutions from court costs and fees associated with litigating their claims against borrowers, costs from which all other kinds of financial institutions are currently exempt. This exemption should be extended to microfinance institutions not only for the sake of eliminating discrimination and leveling the playing field but also because these fees and costs in the cases of larger foundations involve considerable expenses of the kind not suffered by any other kind of financial institution including credit unions as things stand now. There is no policy reason to continue this kind of discrimination against micrefinance institutions. If continued, it could discourage continued donor funding of foundations

F- National Bank Act

19. Article 2 (2) (b)

Insert after the word " bank", the words "non-bank financial institutions".

20. Article 4(1)

Substitute the words "financial institutions" for the word "bank"

21. Article 8 (a)

Insert after the word "bank", the words "and non bank financial institutions"

22. Article 59 (1) (b) and (c)

Insert the words "and non-bank financial institution" after the word "bank"

23. Article 61

Insert the words "and non-bank financial institutions" after the word "bank"

24. Article 75

Insert a new definition as follows:

"Deposit " means " an amount paid to a bank by its customer which becomes the absolute liability of the bank to the customer and which is subject to agreement with the bank to repay it on agreed terms or on demand with or without interest and which has absolute priority in liquidation over other creditors".

The reasons for these recommendations are the same as those set forth in "C" above.

G-The Tax Code of Georgia

25. **Article 51(3)**

Insert the words "and non-bank financial institutions" after the word "banks" on line **1.**

This recommendation will permit microfinance institutions to deduct all funds provisioned into loan loss reserve accounts making them on a par with banks in this crucial area. It will end the current discrimination against microfinance institutions which can now deduct only amounts of bad debts actually written off their books and not provisionings for loan losses. This amendment will particularly benefit depositary microfinance institutions.

H- Law on Entrepreneurs

26. Article 1(2)

Insert "foundations and unions engaged in financial activities as microfinance institutions in fulfillment of their humanitarian goals" after the word (consultants) in line 2.

This amendment will permit NGO non-depositary microfinance foundations and unions to engage in financial activities consistent with their humanitarian goals without risking cancellation of their registrations by officials of courts and the Ministry of Justice because of vagueness and misunderstandings about their power to legally engage in such activities. This legislative relief will serve to remove fear of charter cancellation which hangs as a Sword of Damocles over all such institutions because of official confusion and lack of clear and proper policies with

respect to what they should be doing and how they must achieve their important social goals.

27. Article 59.8

Add a new subparagraph (8) to Article 59, which will read as follows.

"59.8 Financial institutions which engage in limited deposit taking shall be formed as joint stock companies".

This new clause will serve to authorizes microfinance institutions to become licensed by the National Bank under its tiered regulatory scheme. It adds to the legitimatization of depositary microfinance institutions under the amended banking laws as important players in the non-bank sector

I-Code of Civil Procedures

28. Article 59(3)

Insert after the words "labor relations" the words " and the claims of banks and non-bank financial institutions with respect to mortgage foreclosures and debt executions against movable property".

This recommendation will have the effect of placing the claims of financial institutions of all kinds among those plaintiffs deserving of expedited attention by the courts. It is important that the entire financial sector be accorded expedited court treatment of its cases, given the critical national importance of its sustainability. This respectful court treatment which will prevent dilatory actions from hindering and delaying forever justice on its debts. For this reason, all financial institutions should be included among those specially appealing classes which merit this particular treatment as a matter of public policy.

29. Article 252

1.Add at the end of the Article's title the words "and Entrepreneurs".

2. insert "or natural persons involved in entrepreneurial activity" after "legal person" on l. line 1.

These amendments will strengthen the ability of microfinance institutions to enforce their executions against debtors by being included in the class of judgment creditors who can attach against named bank accounts of judgment debtors who are individual persons. It will put an end to the delays currently encountered by microfinance institutions in reaching monies of such these defaulted individuals simply because they are not chartered as some form of company. The current law has been abused by many individuals who are emboldened by it to default on their debts to microfinance institutions (whose borrowing clientele is largely individuals and not enterprises). There is no good policy reason to protect these individuals any longer.

30. Article 268

Add a new subparagraph "g" to the Article moving the current subparagraph "g" down to become new "h". The newly inserted subparagraph will read as follows:

"(g) judgments by banks and non-bank financial institutions against debtors on contracts for borrowed money"

This amendment will permit financial institutions to join that special class of judgment creditors entitled to have their money judgments enforced without delay, i.e. through a hastened enforcement procedure. This class of judgment creditors is favored under the laws of many countries, including Georgia, as a matter of public policy, because their judgments either arise out of humanitarian or labor- related issues or are evidenced by promissory notes which obviate the need to prove a debt by extensive evidence. We believe that, in view of the public importance and role of banks and financial institutions in the national economy and the paramount interest of the government in fostering their continuing solvency, they too should be accorded hastened enforcement treatment of their judgments by being included in this special class of judgment creditors.

31. Article 304

Add at the end of the sentence the words, "or place of business".

This amendment will help microfinance institutions working to collect their debts by summary proceedings to group borrowers and sole proprietorship entrepreneurs by making it much easier to locate them since very often the residences of these debtors are impossible to locate whereas their businesses are easily found. This amendment will permit jurisdiction over such debtors to be quickly established over them by microfinance institutions legally pursuing them on their defaults.

32. Article 348 (2)

Add the words "30 days in advance of the proposed effective date of the cancellation" after "court" on the first line.

This amendment will afford enterprises such as microfinance institutions, in cases involving actions by courts to nullify their charters for general reasons of non-compliance, the same due process and opportunity to be heard described above in the proposed amendment to Article 35 (1) of the Civil Code in cases involving revocations of the registrations of foundations and unions due to alleged wrongful activities.

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III-A CONCLUDING NOTE ON GEORGIAN TRANSLATIONS OF THE PROPOSED AMENDMENTS AND THE ENACTMENT PROCESS

Team GMSE clearly recognizes that the Georgian language translations of the exact English wording proposed for each amendment as set forth above will be controlling and therefore must be accomplished not on a "word-by-word" basis but on an "idea- by-idea" basis. No good translation is ever one of words in any event. Thus, the above English wording proposals, precise as they are, will serve at best to give the most finely tuned sense needed to accomplish the objective of each amendment. It will be the critical task of the professionals who take up the task of translating the proposals to see to it that the true sense of each of them is not eroded or lost as they evolve during necessary consensus building leading up to official legislative sponsorship and thereafter. (Of course, erosions of intent or meaning or other changes made by Parliament or its Committees are an assumed political risk.)

It is therefore comforting to recognize that The Project's Legal Advisor, Mr. Giorgi Otarize, who has played a very significant role in the development of the proposed amendments and their English wording, will take a leading part in the supervision of their official translations as they work their way through the multi-stepped process of finally getting passed. This supervision will be crucial to preserve their integrity as they move forward with the approving consensus of GMSE, USAID, The MFI Policy Coordinating Body, its Legislative Committee and the National Bank of Georgia and on through the stakeholder comment phase, the "Explanatory Note to the Government" stage, finally to be marked-up, explained and defended before the relevant Committees of Parliament on their way to the floor for debate, and enactment before session–end, 2004.

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